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DISSEMINATION: ECON
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C O N F I D E N T I A L SECTION 01 OF 04 TEL AVIV 003960

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FOR GARRY; NSC FOR WATERS; TREASURY FOR HIRSON

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TAGS: ECON EFIN IS PGOV
SUBJECT: ISRAEL'S 2007 STATE BUDGET ATTEMPTS TO BALANCE
WAR-RELATED COSTS WITH CONTINUED FISCAL RESTRAINT

Classified By: Economic Counselor William Weinstein for reasons 1.4 b a
nd d

SUMMARY

¶1. (U) Israel's 2007 state budget, as approved by the Cabinet on September 12, totals approximately NIS 283 billion (USD 65 billion). This represents year-on-year real expenditure growth of 3.3 percent over 2006, consisting of the previously announced 1.7 percent increase plus an additional 1.6 percent for war-related spending. Despite allocating an additional NIS 900-995 million (USD 208-230 million) to ministers' pet projects to secure the Cabinet's support for the budget, the Ministry of Finance (MOF) has managed to maintain the budget's 2007 deficit target of 2.9 percent of GDP. In addition to making these allowances, the government also appointed a Shas minister to a position within the MOF to encourage the party's future support for the budget legislation. The 2007 defense budget amounts to about NIS 48 billion (USD 11 billion) and includes an additional NIS 8.2 billion (USD 1.9 billion), allocated over three years, to finance the refurbishment of the military after the Lebanon conflict. The Bank of Israel (BOI) has tentatively endorsed the 2007 budget and praised the GOI's efforts to continue reducing Israel's public debt levels, but has echoed concerns expressed by other financial analysts about the GOI's plans to increase expenditure levels after 2007. End Summary.

INCREASING EXPENDITURES BECAUSE OF THE WAR

¶2. (U) Israel's 2007 state budget totals approximately NIS 283 billion (USD 65 billion) and is based on assumptions of 4.3 percent GDP growth in 2006 and 3.8 percent growth in ¶2007. (Note: The BOI forecasts GDP growth of 4.6 percent in 2006 and 4 percent in 2007. End Note.) According to the MOF, the 2007 budget includes NIS 1.99 billion (USD 460 million) more in social spending than the 2006 budget. These funds are divided among programs to boost employment (including NIS 700 million - USD 162 million - for increasing the minimum wage), increase welfare payments and National Insurance Institute (NII) allowances, improve spending on healthcare and the medication basket, expand educational programs, and improve benefits for the disabled.

¶3. (U) The year-on-year real expenditure growth of 3.3 percent over the 2006 budget consists of the 1.7 percent spending increase allowed for in the coalition agreements, plus an additional 1.6 percent (NIS 4.5 billion or USD 1.05 billion) increase earmarked for financing expenses related to the Lebanon conflict. In addition, the government plans an additional .5 percent off-budget spending increase to fund continuing disengagement-related expenses.

¶4. (U) The NIS 4.5 billion (USD 1.05 billion) addition to the budget for war-related expenses will be divided between military and civilian needs, with NIS 3.5 billion (USD 810 million) allocated to the Ministry of Defense (MOD) and NIS 1 billion (USD 232 million) designated for civilian use. Another NIS 3.5 billion (USD 810 million) in civilian damage payments should be reimbursed by the GOI's Property Tax and Compensation Fund and, therefore, is not financed in the budget. (Note: Israel's Property Tax and Compensation Fund is financed by the revenues from a national property tax levied by the Israeli Income and Property Tax Commission on businesses. The commission then pays claims on property damage that is the direct result of a hostile terrorist attack on the basis of the market value of a property immediately before the attack. End Note.)

CUTTING TO KEEP DEFICIT IN CHECK

¶5. (U) In order to finance both the regular and war-related budget increases while still maintaining the 2.9 percent deficit constraint, the GOI had to cut NIS 3.85 billion (USD 891 million) from other parts of the budget. Accordingly, the GOI has frozen some NII payments, shelved plans to improve Israel's rail system, postponed some elements of the coalition agreements with Shas and the Pensioners Party, cut other miscellaneous budget items, and shaved 2 percent from some ministries' procurement budgets. Contrary to some press reports, the GOI is not planning to cut child allowances and other transfer payments but is delaying cost-of-living increases in the allowances. (Note: This year, the GOI is suspending a 1.65 percent inflation-linked increase in transfer payments, for a savings of NIS 700 million (USD 162 million). End Note.) The GOI is hoping to fund additional war-related compensation and rehabilitation programs with donations from Jewish communities overseas, which Vice Premier Peres, who is spearheading the fundraising effort, estimates could amount to USD 300 million.

¶6. (U) The GOI so far has managed to uphold the 2007 deficit target of 2.9 percent of GDP. It plans to increase spending by 2.7 percent in 2008 (consisting of the 1.7 percent planned increase plus an additional 1 percent, approximately NIS 2.2 billion (USD 509 million), for the defense budget) and return to a "regular" 1.7 percent hike in 2009. The GOI estimates the deficit target in 2008 will be 2.5 percent of GDP and 1.7 percent in 2009.

GOI BUYS CABINET SUPPORT FOR THE BUDGET

¶7. (U) In order to secure the Cabinet's approval of the 2007 budget legislation on September 12, the MOF allocated an additional NIS 900-995 million (USD 208-230 million) in funding for Cabinet ministers' pet projects. According to the MOF, these additions do not break the 1.7 percent expenditure increase constraint or the 2.9 percent deficit target. (Comment: We presume this means that no other off-setting is required in order to keep the budget within the framework, though these outlays do reduce the amount of funding the MOF has available for buying support in future rounds of debate on the budget in the Knesset Finance Committee and the plenary. End Comment.) According to the MOF, these additional funds will be financed from reserves (pools of funds kept by the MOF to be used to buy support for the budget later in the approval process) and funds originally intended to aid the post-war rehabilitation of northern Israel.

¶8. (U) In exchange for the Cabinet's support of the budget, the MOF allocated additional funding to culture, education, allowances to the elderly, immigrant absorption, agriculture, public housing, the police and prisons service, and tourism. In addition, the GOI added NIS 150 million (USD 35 million) to the budget for the development of the Negev, after Peres, whose office directs the GOI's efforts to develop the Negev and Galilee, threatened to vote against the budget if the Negev received no development funds.

¶9. (U) To maintain the budget framework while making these additional expenditures, the budget for the Chief Scientist's Office in the Ministry of Industry, Trade, and Labor was cut by NIS 150 million (USD 35 million) and NIS 150 million (USD 35 million) worth of coalition promises to Shas were postponed until 2008. (Note: Shas's four Cabinet members opposed the budget in the Cabinet vote on September 12. End Note.) To encourage the party's support of the budget in the future Knesset plenum votes, the GOI agreed to make Shas Knesset member (MK) Mehulam Nahari a minister in the MOF with authority for Haredi education and welfare issues. The future support of the Pensioners Party was encouraged by Prime Minister Olmert's agreement to establish a Pensioners Ministry, as promised to the party in coalition agreements, as a unit within the Prime Minister's office with an initial budget of NIS 15 million (USD 3.5 million).

DEFENSE GETS MORE MONEY

¶10. (U) The 2007 defense budget amounts to about NIS 48 billion (USD 11 billion), roughly 17 percent of the total state budget for the year. To finance the refurbishment of the military after the Lebanon conflict, the defense establishment will receive an increase of NIS 8.2 billion (USD 1.9 billion), allocated over three years. In addition, part of the funds allotted to the defense budget include a NIS 1.15 billion (USD 266 million) supplement described by the GOI as "compensation" to the defense establishment for U.S. disengagement assistance that never materialized, and an extra NIS 1 billion (USD 231 million) for rehabilitating northern Israel after the Lebanon conflict. (Note: The Lebanon war forced the GOI to scuttle plans to cut the defense budget by some NIS 2 billion (USD 465 million) over the next few years in order to free up funds for increased social welfare spending. End Note.) Olmert, for now, has delayed judgment on a post-war MOD request to increase the base defense budget by NIS 30 billion (USD 6.9 billion) over three years to improve the IDF's preparedness and training. Instead, Olmert has appointed a committee, headed by his new economic advisor, Professor Manuel Trajtenberg, to examine the MOD's demands.

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BANK OF ISRAEL TENTATIVELY ENDORSES 2007 BUDGET
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¶11. (U) BOI Governor Fischer on September 12 told reporters that the budget approved by the Cabinet is "basically a good

one." Despite his overall satisfaction with the legislation, Fischer said he would have preferred that the Cabinet offset increased expenditure by raising the Value Added Tax (VAT) to 16.5 percent, which would have augmented the government's revenues by NIS 3.5 billion (USD 810 million), and that the war-related spending increases be limited to one year. The BOI is cautioning the government against increasing the deficit and, as a result, the country's already very high debt burden, since it could undermine investors' confidence in the economy and possibly lead to an increase in Israel's country risk. This could push up medium- and long-term interest rates in the capital markets and, in turn, increase financing costs for the government, business sector, and households. This could be further exacerbated by the BOI's trend of increasing interest rates in line with Federal Reserve interest rate decisions.

MIXED REACTION TO BUDGET OUTSIDE THE GOI

¶12. (U) Following the Cabinet's approval of the budget, international credit rating agency Fitch said that despite concern about the increasing expenditure levels in the budget, Israel would still be able to continue reducing its debt burden as a share of GDP and thereby maintain or improve its sovereign rating. The agency said that although progress in reducing Israel's public debt would slow due to the cost of the war in Lebanon, it would nevertheless continue, provided the fiscal framework endorsed by the Cabinet is upheld. Fitch cautioned, however, that the need to modify the budget to accommodate the cost of the Lebanon war emphasizes once more the vulnerability of Israel's public finances to unexpected and costly shocks emanating from the security situation. This vulnerability, in Fitch's view, means Israel's high public debt ratio is even more of a constraint on its rating than simple comparison with rating peers would suggest.

¶13. (U) Fitch reported that Israel's overall public debt level fell sharply in the first half of 2006, reaching 91 percent of GDP in June, a five-year low, compared to 97 percent of GDP at the start of the year. Fitch now expects this ratio to increase slightly to 93-94 percent of GDP by the end of 2006 as the budget deficit increases and economic growth slows as a result of the Lebanon war. In 2007, Fitch expects Israel's public debt to decline towards 90 percent of GDP, provided the fiscal parameters adopted by the Cabinet are maintained.

¶14. (U) Ratings agency Standard and Poor's (S&P), in critiquing the budget passed by the Cabinet, also emphasized the importance of Israel continuing to reduce its public debt levels despite the increased expenditures necessitated by the Lebanon war. Accordingly, for S&P, the anchor for fiscal policy in 2007 lies in the deficit ceiling of 2.9 percent of GDP and a return to a deficit of 1 percent by 2009, despite the 3.3 percent real expenditure increase in 2007. At the International Monetary Fund (IMF) meetings in late September, S&P analysts expressed concern about Israel's plans to increase expenditures in both 2007 and 2008, remarking that the GOI seems prone to finding a reason for 'one-time' expenditure increases year after year. S&P analysts said such a trend eventually could have a negative influence on Israel's credit rating.

NEXT STEPS

¶15. (C) The GOI probably will bring the budget to the Knesset for a first reading by October 31. After the Knesset first approves the legislation, the budget and the accompanying Economics Arrangements Bill will be returned to the Finance Committee, where additional changes will undoubtedly be made. Following the Finance Committee's final approval, the bills will return to the Knesset plenum, where the second and third readings will take place with the goal of passing the

legislation by December 31, 2006. If the Knesset's approval cannot be secured by the end of the year, the GOI has until March 31, 2007, to pass the budget, or the government will be dissolved and new elections held if another coalition cannot be formed.

COMMENT

¶16. (C) The rest of the approval process for the budget and the Economic Arrangements Bill that accompanies it will not be easy. Despite pledges before the IMF meetings in late September to maintain the government's commitment to continuing fiscal restraint and structural reforms, Finance Minister Hirchson will have a difficult time fending off calls from ministers to increase their own budgets, from partners in the Cabinet to uphold their original coalition agreements, and from the organized labor unions of the Histadrut to suspend privatization and restructuring plans. It is safe to assume many other changes will be made to the budget before it passes, and the high price paid for the Cabinet's approval on September 12 may leave the MOF with few remaining funds to buy the support of wavering MKs. End Comment.

CRETZ